1995

Banks and savings institutions industry developments - 1995/96; Audit risk alerts

American Institute of Certified Public Accountants

AUDIT RISK ALERTS

Banks and Savings Institutions Industry Developments—1995/96

Complement to AICPA Industry Audit Guide *Audits of Banks* and AICPA Audit and Accounting Guide *Audits of Savings Institutions*

AICPA

American Institute of Certified Public Accountants

NOTICE TO READERS

This Audit Risk Alert is intended to provide auditors of financial statements of banks and savings institutions with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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Industry and Economic Developments

The U.S. economy's slow growth during 1995 was reflected in the banking and savings institutions industry by moderate loan growth, tighter liquidity, and declining interest-rate spreads, while capitalization remained strong. These factors, as well as continuing trends of cost control and consolidation within the industry, have various implications for audit risk.

Institutions' efforts to grow loan portfolios or introduce new loan products during the year may involve assumption of greater risk. Changing credit or documentation standards to increase loan originations or accommodate new products may increase audit risk associated with estimates of loan losses.

Growth in loan portfolios has also tightened liquidity at many institutions. Liquidity for funding portfolio activities typically comes from deposits, borrowings, or sales of assets such as securities for institutions to attract new deposits and investors have shifted funds away from existing deposits. Because wholesale borrowings often carry higher interest rates, deposits have been a primary funding source for portfolio growth, resulting in higher loan-to-deposit ratios. In 1994, rates on deposits did not increase to the same degree as market interest rates. As market interest rates went down in 1995, the importance of deposits as a funding source (and the value of related customer relationships as openings to offer other products) kept many institutions from lowering deposit rates to the same degree as decreases in market interest rates. Far from lowering deposit rates to market rates, many institutions had to choose between maintaining or raising deposit rates or using higher cost funds to support portfolio growth, thereby contributing to narrower interest-rate spreads. Auditors should be alert to the effect on audit risk of pressure to maintain or improve interest-rate spreads.

Some institutions have sold securities or loans for liquidity to support portfolio growth. Auditors should be alert to the impact of such sales on management's intent for, classification of, and valuation of securities and loans for financial reporting purposes. Auditors should also be alert to the effect of sales with recourse on credit risk and recognition of gains and losses.

Many institutions have organized personnel, technology, office space, and other resources into structures to support origination of various loan products. When origination volumes are consistently lower than targeted, it becomes more costly to sustain such structures. Auditors should be alert to the impact on audit risk of changes in or dismantling of origination structures.

Consolidation and restructuring within the industry continued during 1995 as institutions anticipate interstate branching and attempt to control costs. Related reductions in staff or elimination or merger of duties increase the potential for weaknesses in knowledge of or adherence to internal controls. Auditors should be alert to such matters when considering an institution's internal control structure as part of a financial statement audit and when testing controls over financial reporting as part of an engagement to attest to related management assertions.

Many institutions have completed restructuring or cost containment programs and are now focused on increasing revenues through new products and fee-based services. Auditors should be alert to the impact on audit risk of new products and services, as well as of related pressures to increase revenues or reduce or defer expenses.

Strong capitalization has funded consolidation, increased dividends, and stock repurchases. Auditors should be alert to audit risk created by these events.

Legislative and Regulatory Developments

Laws and implementing regulations affect the areas and ways in which institutions operate by creating standards with which those institutions must comply. Also, some laws and regulations directly address the responsibilities of auditors. Auditors should be generally familiar with certain laws and regulations because of their impact on auditors'—

- Acceptance of engagements in the industry.
- Development of the expected conduct and scope of an engagement.
- Responsibility for detection of errors, irregularities, and illegal acts.
- Evaluation of contingent liabilities and related disclosures.
- Consideration of an institution's ability to continue as a going concern.

Also, AICPA Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), requires that auditors consider matters, such as government regulations, affecting the industry in which the entity operates. For that purpose, being familiar with the nature and purpose of regulatory examinations—including the differences and the relationship between examinations and financial statement audits—is helpful for auditors. An understanding of the regulatory environment in which banks and savings institutions operate is also necessary to complement the auditor's knowledge of existing regulatory requirements. Because the regulatory environment is continually changing, the auditor should monitor relevant regulatory changes and consider their implications in the audit process.

Following are legislative and regulatory developments of particular significance in audits of the financial statements of banks and savings institutions. Other legislative and regulatory matters covering other policy areas, such as regulations for fair lending practices or the Community Reinvestment Act, are not within the scope of this document. Auditors should be alert to the effect of legislative and regulatory developments on contingent liabilities or planned mergers or acquisitions, or direct and material effects of such developments on the determination of amounts in the institution's financial statements. This Audit Risk Alert does not provide a comprehensive discussion of each issue. Readers should not substitute a reading of this alert for a complete reading of related laws, regulations, rulings, or other documents where appropriate (see the "Information Sources" section herein). This alert refers to related publications of the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), and the Office of Thrift Supervision (OTS) (collectively, the agencies) and other entities as appropriate.

Legislative Matters

Legislation proposed but not passed by Members of Congress during 1995 centered on reforming provisions of the Glass-Steagall Act (which effectively prohibits commercial banks from underwriting securities or otherwise engaging in investment banking activities), providing relief from certain regulations, and further regulating derivatives.

At press time, Congress was also considering legislation related to shoring up the FDIC's Savings Association Insurance Fund (SAIF). In August 1995, the FDIC lowered deposit insurance premiums for many institutions insured by its Bank Insurance Fund (BIF). Given the resulting differential between BIF and SAIF premiums, Congress is considering bills that would merge federal bank and savings institution charters and the BIF and SAIF after raising the SAIF reserve ratio to 1.25 percent through a special assessment of SAIF members. Related legislation has been proposed to address potential recapture by savings institutions of percentage-of-taxable-income deductions of bad debts for tax purposes. Auditors should be alert to the effect of any final legislation on audit risk associated with recognition and measurement of premiums and taxes in an institution's financial statements. (See "Deposit Insurance Premiums" in the "Other Regulatory Matters" subsection herein.)

Regulatory Capital Matters

Capital regulations are complex and their application requires an understanding of specific requirements. The potential impact of noncompliance—particularly if an institution is involved in complex transactions, investments, or parent-subsidiary relationships—also should be understood. Highlights of major changes in capital regulations follow. Readers should consult related regulations for full definitions of the terms used.

Capital Adequacy Guidelines. The FDIC, OCC, and FRB have common capital adequacy guidelines (which differ in some respects from those of the OTS) involving minimum (1) leverage capital and (2) risk-based capital requirements. The leverage requirement establishes a minimum ratio of capital as a percentage of total assets. The FDIC, OCC, and FRB require institutions to maintain a minimum leverage ratio of Tier 1 capital to total average assets based on the institution's rating under the regulatory CAMEL rating system.[1] Capital rules require that institutions with CAMEL ratings of one that are not anticipating or experiencing significant growth and have well-diversified risk maintain a minimum leverage ratio of 3.0 percent. An additional 100 to 200 basis points are required for all but these most highly rated institutions. The risk-based requirement also establishes a minimum ratio of capital as a percentage of total assets, but gives weight to the relative risk of each asset. The FDIC, OCC, and FRB require institutions to maintain a minimum ratio of Tier 1 capital to risk-weighted assets of 4.0 percent. Banks must also maintain a minimum ratio of total capital to risk-weighted assets of 8.0 percent.

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[1] The acronym CAMEL relates to capital adequacy, asset quality, management, earnings, and liquidity.

The OTS requires savings institutions to maintain also a minimum core-capital ratio of 3.0 percent and a tangible capital requirement of 1.5 percent of assets. The determination of tangible capital requires the immediate deduction of all unamortized supervisory goodwill arising from the purchase of a troubled institution before April 12, 1989. Regulations required that institutions fully deduct unamortized supervisory goodwill from core-capital by January 1, 1995. For savings associations, the OTS-required minimum total risk-based capital ratio (that is, the total of core and supplemental capital) is 8.0 percent and the minimum requirement for core capital included in total thrift risk-based capital is 4.0 percent.

Prompt Corrective Action. The FDIC Improvement Act of 1991 (FDICIA) added Section 38 to the Federal Deposit Insurance Act (FDI Act), which outlines a uniform framework for prompt corrective regulatory action. Section 38 focuses regulatory intervention primarily on an institution's capital levels compared with the Section 38 standards. Noncompliance or expected noncompliance with regulatory capital requirements may be a condition, when considered with other factors, that could indicate substantial doubt about an entity's ability to continue as a going concern (as discussed in SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* [AICPA, *Professional Standards*, vol. 1, AU sec. 341]). The application of the prompt corrective action provisions warrants similar attention by auditors when considering an institution's ability to remain a going concern.

Under the provisions, each bank or savings institution falls into one of five regulatory capital categories based primarily on three capital measures: Tier 1 leverage, total risk-based, and Tier 1 risk-based capital. Regulations carrying out Section 38 define the measures in the same manner as for the respective agencies' capital adequacy guidelines and, for savings institutions, Tier 1 leverage capital is comparable to core capital.

Regulations carrying out Section 38 also specify a minimum requirement for tangible equity, which is Tier 1 capital plus cumulative perpetual preferred stock, net of all intangibles except limited amounts of mortgage-servicing rights (MSRs), net of disallowed deferred tax assets. In calculating the tangible capital ratio, intangibles (except qualifying MSRs), net of disallowed deferred tax assets, are deducted from total assets included in the ratio denominator.

Regulators may reclassify an institution into another capital category if they deem the institution's condition or one of its activities to be "unsafe or unsound." A change in an institution's capital category initiates certain mandatory—and possible additional discretionary—action by regulators. Under Section 38, an institution is considered—

1. *Well capitalized* if its capital level *significantly exceeds* the required minimum level for each relevant capital category.
2. *Adequately capitalized* if its capital level *meets* the minimum levels.
3. *Undercapitalized* if its capital level *fails to meet* the minimum levels.
4. *Significantly undercapitalized* if its capital level is *significantly below* the minimum levels.
5. *Critically undercapitalized* if it has a ratio of tangible equity to total assets of 2 percent or less, or otherwise fails to meet the critical capital level.

The minimum levels follow:

Category	*Total Risk-based Ratio (%)*		*Tier 1 Risk-based Ratio (%)*		*Tier 1 Leverage Capital Ratio (%)*
Well capitalized	≥10	and	≥ 6	and	≥ 5
Adequately capitalized	≥ 8	and	≥ 4	and	≥ 4*
Undercapitalized	< 8	or	< 4	or	< 4*
Significantly undercapitalized	< 6	or	< 3	or	< 3

*3.0 percent for institutions with a rating of one under the regulatory CAMEL or related rating system that are not anticipating or experiencing significant growth and have well-diversified risk (as defined).

An institution will not be considered well capitalized if it is under a cease-and-desist order, formal agreement, capital directive, or prompt corrective action capital directive.

Actions regulators may take under the prompt corrective action provisions range from the restriction or prohibition of certain activities to appointment of a receiver or conservator of the institution's net assets.

Regulators will also require undercapitalized institutions to submit a plan for restoring the institution to an acceptable capital category. For example, each undercapitalized institution is required to submit a plan that specifies—

1. Steps the institution will take to become adequately capitalized
2. Targeted capital levels for each year of the plan
3. How the institution will comply with other restrictions or requirements put into effect

4. The types and levels of activities in which the institution will engage

Recourse Arrangements. The agencies revised their risk-based capital guidelines to address capital treatment of low-level recourse arrangements (defined as transactions in which an institution contractually limits its recourse exposure to less than the full effective minimum risk-based capital requirement for the assets transferred). In low-level recourse arrangements, the required amount of risk-based capital is limited to the maximum amount of recourse for which the institution is contractually liable (FDIC Financial Institutions Letter [FIL] 27-95; *Federal Register* [March 28, 1995 and February 13, 1995]).

Interest-Rate Risk. FDI Act Section 18 (added by FDICIA Section 305) requires the agencies to revise their risk-based capital guidelines as necessary to ensure adequate consideration of interest-rate risk.

Effective January 1, 1994, the OTS added an interest-rate risk component to its risk-based capital requirements. Institutions with a greater than normal interest-rate risk exposure (as defined) must take a deduction from the total capital available to meet their risk-based capital requirement, equal to half the difference between the institution's actual measured exposure and a defined normal level of exposure (*Federal Register* [August 31, 1993]). In a March 20, 1995, letter to chief executive officers (CEO Letter), the OTS stated that, in calculating the risk-based capital requirement, no institution will be required to deduct capital for interest-rate risk or to report such a deduction in its call report until the OTS issues a Thrift Bulletin (TB) describing the appeals process for the deduction.

The FDIC, OCC, and FRB issued a final rule that amends risk-based capital standards to explicitly identify concentrations of interest-rate risk as qualitative factors to be considered in assessing an institution's overall capital adequacy. The final rule includes no quantitative measure of such risks. The FDIC, OCC, and FRB also proposed a joint policy statement on methods by which interest-rate risk exposure will be assessed for supervisory purposes (OCC Bulletin 95-46; *Federal Register* [August 2, 1995]).

OCC Advisory Letter 95-1 and OCC Bulletin 95-28 express the OCC's expectations regarding banks' interest-rate risk management practices. FDIC FIL-60-94 includes guidance to FDIC examiners on assessment and management of interest-rate risk. These documents may also provide useful information to auditors.

Concentration of Credit Risk and Nontraditional Activities. In December 1994, the agencies issued final rules for regulatory consideration of concentrations of credit risk and risks of nontraditional activities (FDIC FIL-85-94; *Federal Register* [December 15, 1994]). The final rule amends existing risk-based capital standards explicitly to identify concentrations of credit risk and risks of nontraditional activities as qualitative factors to be considered by the agencies' examiners in assessing an institution's overall capital adequacy. The final rule includes no quantitative measure of such risks.

The OCC requires regulatory examination reports to include certain information about concentrations of credit (as defined) (OCC Bulletins 95-7 and 95-26). Although the definition of concentrations of credit is not equivalent to that used for purposes of disclosure in conformity with Financial Accounting Standards Board (FASB) Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (FASB, *Current Text*, vol. 1, sec. F25), examination reports are available to auditors, who may find the regulatory summary helpful as one source of information for addressing the completeness of related financial statement disclosures.

Market Risk. In July 1995, the FDIC, OCC, and FRB issued a proposal to amend their risk-based capital guidelines to incorporate a measure of market risk (OCC Bulletin 95-42; *Federal Register* [July 25, 1995]). The FRB also issued a request for comments on a possible approach to setting capital requirements for market risk (*Federal Register* [July 25, 1995]).

RAP-GAAP Differences. Auditors should also consider the effect on audit risk of differences between regulatory accounting practices (RAP) used to prepare regulatory financial reports and generally accepted accounting principles (GAAP) used to prepare general-purpose financial statements. For example, the FASB's Emerging Issues Task Force (EITF) reached a consensus on EITF Issue No. 85-44, *Differences between Loan Loss Allowances for GAAP and RAP*, that an institution could record different loan loss allowances under RAP and GAAP because those amounts may differ due to the subjectivity involved in estimating the amount of loss or the use of arbitrary factors by regulators. However, the consensus suggests that auditors should be particularly skeptical of such RAP-GAAP differences in loan loss allowances and must justify such differences based on the circumstances.

Also, because of regulatory rule changes during the year, certain balances and transactions accounted for in conformity with GAAP for regulatory reporting purposes will receive special treatment in regulatory capital calculations. Descriptions of these transactions follow.

- *Deferred Tax Assets.* Only a limited amount of certain deferred tax assets recognized under FASB Statement No. 109, *Accounting for Income Taxes* (FASB, *Current Text,* vol. 1, sec. I27), may be included in Tier 1 capital (FDIC FIL-16-95; *Federal Register* [February 13, 1995 and December 22, 1994]; OCC Bulletin 95-10; OTS TB 56).
- *Securities Gains and Losses.* Net unrealized holding losses on equity securities classified as available for sale in conformity with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FASB, *Current Text,* vol. 1, sec. I80), are included in the calculation of Tier 1 capital. However, all other unrealized holding gains and losses on available-for-sale securities are not included in calculation of Tier 1 capital (FDIC FIL-3-95; OCC Bulletin 94-68; OTS CEO Letter [November 28, 1994]; *Federal Register* [December 8, 1994]).
- *Loan Loss Allowances.* Regulations permit institutions to include in Tier 2 capital a limited amount of loan loss allowances established in conformity with FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (FASB, *Current Text,* vol. 1, sec. I08), whereas these amounts reduce assets (rather than increase capital) for GAAP purposes. The notice of the Federal Financial Institutions Examination Council's (FFIEC's) final action appeared in the *Federal Register* on February 10, 1995. Further, through OTS Regulatory Bulletin (RB) 32, the OTS revised its policies to require that the valuation and classification of troubled, collateral-dependent loans (as defined) in regulatory financial reports "should be based on the fair value of collateral, and not on the present value of expected future cash flows nor on the loan's observable market price."
- *Offsetting of Repurchase and Reverse Repurchase Agreements.* The OTS follows GAAP established in FASB Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements* (FASB, *Current Text,* vol. 1, sec. B10) (see the "Accounting Developments" section herein). The FDIC, OCC, and FRB generally prohibit netting for repurchase and reverse repurchase agreements, including those that fall within the scope of FASB Interpretation No. 41.

In August 1995, the agencies issued an interim final rule on regulatory accounting and capital treatment of mortgage servicing rights (FDIC FIL-56-95; *Federal Register* [August 1, 1995]). The interim rule permits both originated and purchased mortgage servicing rights to be included in (that is, not deducted from) Tier 1 capital subject to certain limitations.

Other Regulatory Matters

FDI Act Section 36—Reporting Requirements.[2] Several regulatory releases in the past year relate to additional guidance on or amendments to the regulations carrying out FDI Act Section 36.

The FDIC proposed additional guidance on annual reporting requirements that, in part, would make technical changes to required compliance attestation procedures. The FDIC also referred managements and auditors to the May 1994 addendum to the Committee of Sponsoring Organizations of the Treadway Commission's (COSO's) September 1992 report *Internal Control—Integrated Framework* (Product No. 990008) for reporting guidance on internal controls involving safeguarding of assets. Although the comment period has closed and no final rule has been issued, the FDIC said it would not object if a bank or savings institution chooses to follow the proposal when preparing required assertions and auditors' reports (FDIC FIL-19-95 and FIL-86-94; *Federal Register* [February 15, 1995]).

Following are descriptions of recent actions that involve laws and regulations addressed in 12 CFR Part 363's required management compliance assertions and related attestation procedures.

- The FRB issued final changes to 12 CFR Part 215 (Regulation O) that, effective April 7, 1995, remove requirements that an institution's board of directors provide prior approval on loans made to executive officers that are secured by a first lien on the executive officer's residence (FDIC FIL-5-95; OTS TB 64-1; *Federal Register* [February 15, 1995]).
- The OCC issued OCC Bulletin 94-41, which interprets Title 12 of the United States Code (12 USC) 60(b) to allow OCC supervisory offices to grant prior approval for national banks' dividend requests subject to the law before the period in which dividends would be declared.

[2] The audit and other reporting requirements created in FDI Act Section 36 (as added by FDICIA Section 112), and related implementing regulations contained in Title 12 of the Code of Federal Regulations (12 CFR) Part 363, were discussed in detail in the AICPA Audit Risk Alert *FDIC Improvement Act Implementation Issues* (Product No. 022140). Those and related discussions in the AICPA's Audit Risk Alerts *Banks and Savings Institutions Industry Developments—1994* and *Banks and Savings Institutions Industry Developments—1993* have been incorporated into an appendix of the proposed AICPA Audit and Accounting Guide *Banks and Savings Institutions*. See the "Audit and Accounting Guide" section herein.

FDI Act Section 39—Safety and Soundness Guidelines. The Riegle Community Development and Regulatory Improvement Act of 1994 (Public Law [P.L.] 103-325) included amendments to FDI Act Section 39 to allow regulators to carry out Section 39's provisions through the issuance of guidelines rather than more rigid regulations. The agencies issued final rules and guidelines carrying out Section 39 which, among other matters, include guidelines for internal controls and internal audit systems, as defined (*Federal Register* [July 10, 1995]).

Specifically, the final rules state that the agencies believe their internal control requirements are consistent with the guidelines in COSO's report *Internal Control—Integrated Framework.* The agencies concluded, therefore, that using the COSO framework in developing and evaluating internal controls is one way an institution's management could meet the standards proposed by the agencies.

The final rules also highlight that, although many institutions use data processing service organizations, the determination of whether an auditor needs to review those operations as they relate to internal controls should be made in accordance with general accepted auditing standards (GAAS).

Examiner-Auditor Relationship. Auditors often are engaged to attest to the fairness of presentation of an institution's financial statements and to management assertions about an institution's financial reporting controls and compliance with laws and regulations. Regulators conduct periodic on-site examinations to address broader regulatory and supervisory issues. In September 1994, the Group of Thirty (an international financial policy organization) issued its report *Defining the Roles of Accountants, Bankers and Regulators in the United States.* In part, the report cites a need for closer cooperation, and elimination of unnecessary overlap, among managements, auditors, and examiners.

The proposed AICPA Audit and Accounting Guide *Banks and Savings Institutions* explains that examiners and auditors share some objectives, and that coordination in consultation with the institution may be beneficial (see appendix). The Guide incorporates and supersedes AICPA Statement of Position (SOP) 90-5, *Inquiries of Representatives of Financial Institution Regulatory Agencies,* and related sections of the AICPA Audit and Accounting Guide *Audits of Savings Institutions.*

The agencies' July 23, 1992 *Interagency Policy Statement on Coordination and Communication Between External Auditors and Examiners* (FDIC FIL-57-92) addresses information that institutions should provide to auditors of their financial statements (including requirements of FDI

Act Section 36). The policy statement also provides guidance for participation by auditors at meetings between an institution's management and examiners.

The policy statement encourages institutions to advise their auditors promptly of the dates and scope of supervisory examinations to simplify the auditor's planning and scheduling of work. The policy statement also encourages institutions to give their auditors a report of any actions initiated or undertaken by a federal banking agency since the beginning of the period covered by the audit, or of any similar action taken by an appropriate state bank supervisor. The policy statement encourages auditors to attend examination exit conferences upon completion of field work or other meetings between supervisory examiners and an institution's management or board of directors at which examination findings are discussed that are relevant to the scope of the audit. In addition, the auditor may request a meeting with any or all of the appropriate agencies involved in the supervision of the institution or its holding company during or after completion of examinations to ask about supervisory matters relevant to the institution whose financial statements they are auditing.

Frequency and Nature of Examinations. In January 1995, the OCC amended its requirements for the frequency of on-site safety and soundness examinations effective September 23, 1994, as required by Section 306 of the Riegle Community Development and Regulatory Improvement Act of 1994 (OCC Bulletin 95-4). Under the revised requirements, every national bank must undergo a full-scope, on-site regulatory examination not less than once every twelve months; however, the OCC may extend some periods to eighteen months if certain criteria are met. In July 1994, the OCC issued guidance on *Community Bank Examination Procedures for Noncomplex Banks.* The guidance defined certain banks as noncomplex and set minimum scope requirements for on-site regulatory activity for such banks. Auditors should be alert to the effect changes in the frequency and nature of exams may have on their coordination with examiners.

Deposit Insurance Premiums. Section 7(b) of the FDI Act, as amended by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the FDICIA, requires the FDIC to maintain the BIF and the SAIF at minimum reserve ratios of insurance funds to insured deposits of 1.25 percent. To achieve these ratios, the FDIC increased premiums to an average of 23.2 cents per $100 of insured deposits. Section 7(b) also allows the FDIC's Board of Directors to increase either fund's reserve ratio beyond 1.25 percent of estimated insured deposits if there is a significant risk of substantial future losses to the fund.

On August 8, 1995, the Board voted to reduce BIF premiums to an average 4.4 cents per $100 of insured deposits once the BIF reached the 1.25 percent reserve ratio. On September 5, 1995, the FDIC confirmed that the BIF passed the 1.25 percent reserve ratio by May 31, 1995 (FDIC News Release PR-54-95). The FDIC announced it would refund BIF-member institutions the difference between payments under the new and old premium rates since June 1, 1995. The FDIC paid institutions the refund and related interest on September 15, 1995 (FDIC FIL-58-95). Auditors should be alert to the effect of this action on audit risk associated with recognition and measurement of premiums in an institution's financial statements.

The SAIF reserve ratio is well below 1.25 percent, in part because some premiums received are used to pay interest on Financing Corporation (FICO) bonds. (The proceeds from FICO bonds funded past closings of failed institutions.) On August 8, 1995, the FDIC's Board of Directors voted to keep SAIF premiums at existing rates. (See "Legislative Matters" in the "Legislative and Regulatory Developments" section herein.) Auditors should be alert to the effect on audit risk of disclosures about the potential for a special SAIF assessment and accounting for such an assessment if enacted.

Derivatives Activities. In June 1995, the OCC released a report on best practices used by the most active multinational banks that sell derivative financial instruments. In October 1994, the OCC issued guidance to national bank examiners for evaluating the adequacy of risk management practices that national banks use in derivatives activities. The document entitled *Risk Management of Financial Derivatives* was incorporated into the OCC's *Comptroller's Handbook.* FRB Supervisory Release (SR) 95-17 discusses risk management and internal controls for securities and derivatives used in nontrading activities. The FRB's "Trading Activities Manual" includes guidance for examiners on capital markets and trading activities. Auditors may find these documents helpful in understanding risks associated with derivatives.

Quasi-Reorganizations. The OCC revised requirements for banks applying for permission to complete quasi-reorganizations, including accounting treatment of quasi-reorganizations in regulatory financial reports (OCC Bulletin 95-27).

Loan Losses. The FDIC and FRB issued guidance to examiners on applying FASB Statement No. 114 in Transmittal No. 95-051 and SR 95-38, respectively.

Loan Losses at U.S. Branches and Agencies of Foreign Banks. In January 1995, the FRB announced elimination of its requirement that uninsured United States branches and agencies of foreign banks establish and maintain loan loss allowances separate from those of the foreign banks. The FRB emphasized its continuing policy requiring uninsured United States branches and agencies of foreign banks to establish and maintain procedures for identifying loan losses. The OCC clarified that the FRB's decision does not alter the OCC's requirement that each branch or agency maintain loan loss allowances as required by the OCC's February 1992 Banking Circular 201 and July 1993 Agency Circular No. 1 (OCC Bulletin 95-15).

Shared National Credits. The agencies have an interagency Shared National Credit Program for review and risk assessment of the largest and most complex credits shared by multiple financial institutions. OCC Bulletin 95-9's description and guidelines for the Shared National Credit Program may provide helpful information to auditors of the financial statements of institutions that share credit risk of loans or loan commitments that aggregate $20 million.

OTS Audit Requirements. The OTS amended its annual financial-statement audit requirement for savings institutions, eliminating the mandatory annual financial-statement audit requirement for institutions having less than $500 million in assets and CAMEL ratings of one or two. Under the final rule, the OTS may require an independent audit of financial statements or performance of agreed-upon procedures for safety and soundness reasons, including requiring reports for institutions that have received CAMEL ratings of 3, 4, or 5 or savings and loan holding companies that control savings association subsidiaries with aggregate consolidated assets of $500 million or more (OTS RB 32-1; *Federal Register* [November 23, 1994]).

Stock Transfer Agent Reports. In February 1995, the AICPA's Auditing Standards Board (ASB) requested that the Securities and Exchange Commission (SEC) staff adopt a "no action" position for reports on a transfer agent's internal control structure; specifically, that reports based on AICPA Statement on Standards for Attestation Engagements (SSAE) No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting* (AICPA, *Professional Standards,* vol. 1, AT sec. 400), be considered in compliance with Rule 17Ad-13 of the Securities Exchange Act of 1934. (Such reports were previously prepared under SAS No. 30, *Reporting on Internal Accounting Control,* before SSAE No. 2 superseded it.)

In April 1995, an SEC staff letter to the AICPA stated that the SEC will take no action if reports on the internal control structure of transfer agents are prepared in accordance with SSAE No. 2. Following is an illustrative transfer agent report developed by the ASB and to which the SEC staff would not object.

Independent Accountant's Report

Board of Directors
Example Bank:

We have examined management's assertion that "Example Bank maintained an effective internal control structure, including the appropriate segregation of responsibilities and duties, over the transfer agent and registrar functions, as of October 31, 19X5, and that no material inadequacies as defined by Rule 17Ad-13(a)(3) of the Securities Exchange Act of 1934 existed at such date."[3]

Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included a study and evaluation of the internal control structure over the transfer agent and registrar functions, using the objectives set forth in Rule 17Ad-13(a)(3) of the Securities Exchange Act of 1934. Those objectives are to provide reasonable, but not absolute, assurance that securities and funds are safeguarded against loss from unauthorized use or disposition and that transfer agent activities are performed promptly and accurately. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control structure over the transfer agent and registrar functions to future periods are subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion that, as of October 31, 19X5, Example Bank maintained an effective internal control structure, including the appropriate segregation of responsibilities and duties, over the transfer agent and registrar functions, and that no material inadequacies existed as defined by Rule 17Ad-13(a)(3) of the Securities Exchange Act of 1934, is fairly stated, in all material respects, based on the criteria established by Rule 17Ad-13(a)(3) of the Securities Exchange Act of 1934.

This report is intended solely for the information and use of the board of directors and management of Example Bank and for the Securities and Exchange Commission and should not be used for any other purpose.

December 15, 19X5

[3] Management's assertion should be appropriately segregated by quotation marks using the language noted, which is also included in management's representation letter to the practitioner.

HUD Annual Lender Recertification Requirements. Bank and savings institution subsidiaries and affiliates that are mortgagees under certain mortgage insurance programs administered by the United States Department of Housing and Urban Development (HUD) should be aware of certain requirements for annual audits of financial statements. HUD Mortgagee Letter 95-6 provides additional information.

Lender Reports. In 1992, Congress amended the Higher Education Act of 1965 (HEA) to require compliance engagements for lenders who participate in Federal Family Education Loan (FFEL) programs. Many banks and savings institutions are subject to the requirements because they participate as lenders in these FFEL programs, which include the Federal Stafford Loan Program (formerly the Guaranteed Student Loan Program), the Federal Supplemental Loans for Students Program, the Federal PLUS Program, and the Federal Consolidation Loan Program.

In late 1992, the United States Department of Education (ED) issued implementing regulations, specifying that they would define procedures for conducting the engagements in a guide the ED's Office of the Inspector General (OIG) would develop. The regulations made the reporting requirement effective for fiscal years beginning after July 23, 1992. The OIG issued the Guide, *Compliance Audits (Attestation Engagements) of Federal Family Education Loan Program at Participating Lenders,* in March 1995.

The Guide generally requires an examination of management assertions about compliance with certain requirements for preparation of the *Lender's Interest and Special Request and Reports* (ED Form 799), performed, in part, in accordance with SSAE No. 3, *Compliance Attestation* (AICPA, *Professional Standards,* vol. 1, AT sec. 500). The HEA also requires that the engagements be performed in accordance with the United States General Accounting Office's (GAO's) *Government Auditing Standards,* which include general standards for an external quality control review and for continuing education requirements.

In a September 14, 1995, letter, the ED extended the due date for reports from lenders with portfolios equal to or less than $5 million (as defined) until June 30, 1996.

Auditors may wish to discuss the reporting requirements with clients.

Lender/Guaranty Agency Servicer Reports. Institutions participating as third-party servicers for *lender or guaranty agencies* in the ED's Title IV programs under the HEA are required by 12 CFR Subpart 682.416(e) to have independent audits of their administration of the participation in the FFEL programs (*Federal Register* [April 29, 1994]).

Further, 34 CFR Subpart 668.23(c)(1)(ii) requires institutions participating as third-party servicers for *educational institutions* in the Title IV programs (for example, Federal Perkins Loan) to have independent audits (that meet the compliance audit standards for educational institutions) of the servicer's administration of the participation in the Title IV programs (*Federal Register* [November 29, 1994]).

Implementing regulations state that procedures for conducting the audits are available in a guide developed by the ED's OIG. The OIG is drafting—but has not yet issued—such a guide. Accordingly, the OIG has delayed the due dates for required reports until after they issue a guide. The regulations specify effective dates for the audits covering the first full fiscal year (for lender and guaranty agency servicers) or award year (for education institution servicers) beginning on or after July 1, 1994. The regulations specify that the audits must be conducted in accordance with the GAO's *Government Auditing Standards.* The regulations exempt third-party servicers that contract with only one lender or guaranty agency (or educational institution) from the audit requirement if the lender or guaranty agency (or educational institution) has had an audit covering the servicer's administration.

Auditors may wish to discuss the reporting requirements with clients.

"Exceptional Performance Standards" Reports. Beginning July 1, 1995, the HEA allows institutions participating as lenders or lender servicers in FFEL programs voluntarily to seek "exceptional performance" status based on their performance collecting delinquent and defaulted FFEL program loans. "Exceptional performance" designation by the Secretary of Education makes a lender or lender servicer eligible to be reimbursed 100 percent for insurance claims submitted for twelve months from the date the ED notifies them of the designation. 34 CFR Subpart 682.415(a)(2) establishes qualifications for exceptional performance status, including a required report on a compliance audit of the lender's or lender servicer's loan portfolio that reports a compliance performance percentage of 97 percent or higher (as defined). The ED's OIG is preparing a guide that would specify procedures to be performed and reported on in accordance with SSAE No. 3 and the GAO's *Government Auditing Standards.* The guide would also include procedures for sampling and calculating the performance compliance percentage.

Auditors may wish to discuss the reporting requirements with clients.

SEC Actions

During the year, the SEC staff has expressed its views on accounting for various transactions in public speeches and comments on registrants' filings (see the "Information Sources" section herein). Auditors should be alert to the audit risk associated with related matters, which include the following:

- Identifying and using the predominant risk characteristics of underlying loans to stratify mortgage servicing rights for purposes of applying the impairment provisions of FASB Statement No. 122, *Accounting for Mortgage Servicing Rights* (FASB, *Current Text*, vol. 2, sec. Mo4).
- Accounting for financial instruments as "hedges" of mortgage servicing rights
- Accounting for swaps that are leveraged, swaps designated to equity instruments, swaps not designated, swaps designed to front-load income, and swaps held for speculative purposes
- Improper classification of liabilities for credit losses on off-balance-sheet financial instruments
- Sale or transfer of a held-to-maturity security due to a change in circumstances other than a change in circumstances identified in paragraph 8 of FASB Statement No. 115 and, therefore, considered inconsistent with the security's original classification

GAO Reports

The following GAO reports issued in the past year may give auditors helpful information about current industry issues:

1. *Depository Institutions: Divergent Loan Loss Methods Undermine Usefulness of Financial Reports* (October 1994: GAO/AIMD-95-8)
2. *Deposit Insurance Funds: Analysis of Insurance Premium Disparity Between Banks and Thrifts* (March 1995: GAO/AIMD-95-84)

Audit and Accounting Guide

In early 1996, the AICPA will issue an AICPA Audit and Accounting Guide *Banks and Savings Institutions*. The Guide supersedes the AICPA Industry Audit Guide *Audits of Banks* and the AICPA Audit and Accounting Guide *Audits of Savings Institutions*. The Guide discusses those aspects of accounting and auditing unique to banks and savings institutions and was developed to help preparers and auditors of financial statements of banks and savings institutions. The Guide incorporates new accounting and financial reporting requirements issued by the FASB and the AICPA's Accounting Standards Executive Committee (AcSEC), and new auditing standards issued by the ASB, since issuance of the guides that would be superseded.

The Guide establishes new requirements for disclosures about regulatory matters effective for financial statements issued for fiscal years ending after June 15, 1996, and for interim financial statements issued after initial application. The auditing provisions of the Guide will be required to be applied prospectively to audits of financial statements for fiscal years ending after June 15, 1996.

Audit Issues and Developments

Asset Quality and Valuation Issues

Auditors of the financial statements of banks and savings institutions should give special attention to credit quality and other asset quality issues surrounding commercial and consumer loans, real estate portfolios, troubled debt restructurings, foreclosed assets and other real estate owned, off-balance-sheet financial instruments, and other assets. Auditors should obtain sufficient competent evidence to evaluate the adequacy of management's loan loss allowance and liabilities for other credit exposures. The subjectivity of determining such amounts, combined with the issues discussed in the "Industry and Economic Developments" section herein, reinforces the need for careful planning and execution of audit procedures in this area, as well as evaluation of results of those procedures.

Lack of an effective system to evaluate credit exposure and other sources of impairment or failure of an institution to document adequately its criteria and methods for determining loan loss allowances may suggest a reportable condition or a material weakness in the institution's internal control structure over financial reporting. These deficiencies would generally (1) increase the judgment auditors and regulatory examiners must apply in evaluating the adequacy of management's related allowances and liabilities, and (2) increase the likelihood that differences in judgments will result. The guidance in SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards,* vol. 1, AU sec. 342), is useful when considering this area. The AICPA Auditing Procedure Study *Auditing the Allowance for Credit Losses of Banks* (Product No. 021050) is another source of information on auditing estimated credit losses. (See "Risk and Uncertainties" in the "Accounting Standards Executive Committee Activities" subsection herein.)

Auditors should also be alert to valuation issues related to classification and impairment of securities. Paragraph 16 of FASB Statement No. 115 requires that, for individual securities classified as either available-for-sale or held-to-maturity (as defined), an institution should determine whether a decline in fair value below the amortized cost basis is other than temporary.

Paragraph 69 of FASB Statement No. 115 says "if the sale of a held-to-maturity security occurs without justification, the materiality of that contradiction of the enterprise's previously asserted intent must be evaluated." The SEC staff is interpreting paragraph 69 of FASB Statement No. 115 to mean that if held-to-maturity securities are transferred or sold due to changes in circumstances other than those listed in paragraph 8 of FASB Statement No. 115, the SEC staff will challenge management's (1) assertions about the classification of other held-to-maturity securities and (2) future assertions regarding the classification of securities purchased subsequently for an extended period of time, no less than one year.

Other factors that may affect audit risk include the entity's exposure to interest-rate, liquidity, prepayment, and other risks. For example, institutions heavily invested in fixed-rate assets (or variable-rate assets subject to caps on interest-rate increases) may face narrower spreads in a rising-rate environment. Auditors also should be alert to the effects interest-rate increases could have on borrowers' ability to repay loans and the effects interest-rate decreases could have on the realization of assets that are sensitive to prepayments (such as mortgage servicing rights and interest-only securities). Institutions with large volumes of money market or other short-term deposit liabilities are subject to greater liquidity risk because those liabilities must be refinanced.

Noncompliance With Capital Adequacy and Other Regulatory Requirements

Events of noncompliance with regulatory requirements, such as failure to meet minimum capital requirements or participation in impermissible activities or investments, expose banks and savings institutions to regulatory action. Events of noncompliance may be brought to the auditor's attention during the application of normal auditing procedures, during the review of regulatory examination reports, or because of actions required by regulators.

SAS No. 59 states that "the auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited." Noncompliance with regulatory capital requirements is a condition, when considered with other factors, that could indicate substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. SAS No. 59 identifies examples of other factors that the auditor may evaluate.

Investments in Derivatives

Recent years have seen a growing use of innovative financial instruments, commonly referred to as derivatives, that often are very complex and can involve a substantial risk of loss. As interest rates, commodity prices, and many other market rates and indices from which certain financial instruments (derivatives) derive their value have been volatile over the past several months, several entities have incurred significant losses because of their use. Banks and savings institutions sometimes use derivatives as risk management tools or as speculative investment vehicles. The use of derivatives often increases audit risk. Although financial statement assertions about derivatives are generally similar to assertions about other transactions, the auditor's approach to achieving related audit objectives may differ because the notional and contractual amounts of certain derivatives—such as futures, forwards, swaps, options, and other contracts with similar characteristics—are not generally recognized in the financial statements. Auditors should understand both the economics of derivatives used by an institution and the nature and business purpose of the institution's derivatives activities. In addition, auditors should evaluate accounting for any such instruments, especially those reported at amounts other than fair value. To the extent the derivatives qualify as financial instruments as defined in FASB Statements No. 105, No. 107, *Disclosures about Fair Value of Financial Instruments* (FASB, *Current Text*, vol. 1, sec. F25), and No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FASB, *Current Text*, vol. 1, sec. F25), the disclosure requirements set forth in those statements must be met. When derivatives are accounted for as hedges of on-balance-sheet assets or liabilities or of anticipated transactions, auditors should carefully review the appropriateness of the use of hedge accounting, particularly considering whether the criteria set forth in applicable authoritative accounting literature are met.

Audit risk considerations presented by the use of derivatives are discussed in *Audit Risk Alert—1995/96*. The AICPA publication *Derivatives—Current Accounting and Auditing Literature* (Product No. 014888) summarizes current authoritative accounting and auditing guidance and provides background information on basic derivatives contracts, risks, and other general considerations. (See "Disclosures About Derivatives" in the "Accounting Developments" section herein.)

An advisory council to COSO has been preparing a guide on applying COSO's *Internal Control—Integrated Framework* to derivatives activities. COSO plans to issue a final guide in 1996.

Electronic Funds Transfer Association Engagements

Some electronic funds transfer (EFT) associations or networks require their members who process transactions to complete a "compliance review." For example, institutions with automated teller machines that use one or more EFT associations or networks may be required to provide related auditor reports.

Some EFT association requirements intend for auditors to (1) complete a questionnaire about an institution's compliance with the EFT association's operating rules and procedures related to internal controls over security and (2) sign a "certification" statement that the institution is in compliance with such operating rules and procedures.

SSAE No. 3 governs engagements of this nature. Auditors who are asked to perform such engagements should determine whether the actions that are required conflict with SSAE No. 3. For example, "certification" statements may extend an auditor's responsibility significantly beyond the limits of professional standards. Sometimes, the statements prescribed by the EFT association refer to GAAS or other professional standards that do not apply to such services. Such statements also may refer to the auditor's review of compliance; however, SSAE No. 3 prohibits review services related to compliance, permitting only examination (assuming certain conditions exist) or agreed-upon-procedures engagements. Furthermore, compliance questionnaires often ask for responses to questions about compliance without providing sufficiently objective criteria for determining when compliance does or does not exist.

Mortgage Banking Engagements

In May 1995, the Mortgage Bankers Association of America (MBA) released its revised *Uniform Single Attestation Program for Mortgage Bankers* (USAP). The USAP supersedes MBA's existing program (published in 1983) with an opinion-level attestation engagement performed following SSAE No. 3. Specifically, MBA redefined the engagement to address mortgage servicing companies' compliance with the USAP's specified minimum servicing standards. The USAP will be effective for fiscal years ending on or after December 15, 1995, and later, with earlier application encouraged.

In a September 1995 letter to its members, the MBA said that commercial and multifamily loan servicers could report using the USAP, except that minimum standards V.4 and VI.1 could be omitted from management's assertion and the auditor's attestation reports. In the letter, the MBA described a project under way to consider amending or expanding the USAP to explicitly address reporting by commercial and multifamily loan servicers.

The USAP addresses reporting on management assertions about an entity's compliance with specified criteria. SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards,* vol. 1, AU sec. 324), provides guidance on factors auditors should consider when auditing the financial statements of entities that use service organizations (such as mortgage bankers that service mortgages for others). Information about the control structure policies and procedures at mortgage bankers or other loan servicing organizations may affect assertions in the user entity's financial statements. Also, some service auditors' reports prepared according to SAS No. 70 include descriptions and results of tests of operating effectiveness of specified control policies and procedures. Accordingly, those SAS No. 70 reports may enable an auditor of the financial statements of a user entity to assess control risk below the maximum of relevant financial statement assertions. Readers should consult SAS No. 70 for additional information on how to use a service auditor's report when auditing the financial statements of a user organization.

The Federal Home Loan Mortgage Corporation (Freddie Mac) sent a September 29, 1995 letter to chief financial officers of its seller/servicers announcing that, effective immediately, Freddie Mac no longer requires an independent accountant's agreed-upon-procedures attestation report on compliance with requirements of Freddie Mac's programs. The report previously was required by Freddie Mac's 1993 *Compliance Reporting Guide.* Readers should be alert to a Freddie Mac bulletin that will be issued explaining the change and clarifying Freddie Mac's other independent audit requirements.

SAS No. 70 Auditing Procedure Study

A task force of the ASB has drafted an auditing procedure study that provides guidance to auditors on implementing SAS No. 70. The study provides guidance to a service auditor engaged to issue a report on the control structure policies and procedures of a service organization. It also provides guidance to user auditors engaged to audit the financial statements of an entity that uses a service organization. An example of a service organization is a bank trust department that invests and holds assets for employee benefit plans. The task force expects to issue the study in early 1996.

Agreed-Upon Procedures Engagements

In September 1995, the AICPA issued SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*, vol. 1, AU sec. 622), which will supersede SAS No. 35, *Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*. The AICPA also issued SSAE No. 4, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 600), which would, among other things, amend reports on agreed-upon procedures performed in accordance with SSAE No. 3. SAS No. 75 and SSAE No. 4 are effective for reports dated after April 30, 1996, with earlier application encouraged.

Among other significant provisions, SAS No. 75 and SSAE No. 4—

- Prohibit negative assurance about whether management's assertion is fairly stated from being included in reports on agreed-upon procedures.
- Clarify that SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 322), does not apply to agreed-upon procedures engagements.
- State that the concept of materiality does not apply to agreed-upon procedures engagements unless the definition of materiality is agreed to by the specified users.

SSAE No. 4 also requires a written management assertion as a condition of engagement performance.

The appendix to the exposure draft of the AICPA Audit and Accounting Guide *Banks and Savings Institutions* entitled "Suggested Guidelines for CPAs Participating in Bank Directors' Examinations" will be omitted from the final guide. The AICPA Banking and Savings Institutions Committee is studying the need for changes in related guidance due to changes in legal requirements and professional standards. Auditors should consult SAS No. 75 and SSAE No. 4 for engagements that fall within their scopes. For agreed-upon procedures engagements related to management assertions about the entity's compliance or the entity's internal control structure over financial reporting, the auditor should consult SSAE No. 3 (as amended) and SSAE No. 2, respectively.

Examples of other engagements affected by SAS No. 75 or SSAE No. 4 include those to report on agreed-upon procedures relating to management assertions about:

- Collateral for Federal Home Loan Bank advances
- Compliance with EFT association requirements
- Compliance with FFEL program requirements (see the "Other Regulatory Matters" section herein)
- Compliance with safety and soundness laws and regulations designated in 12 CFR Part 363 (see the "Other Regulatory Matters" section herein)
- Compliance with bond-selling-group agreements
- Officers' expenses
- Trust activities

Auditors should be alert to the effects of SAS No. 75 and SSAE No. 4 on these and similar engagements.

Elimination of Uncertainty Reporting

In July 1995, the ASB issued an exposure draft of a proposed Statement on Auditing Standards, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements, that would eliminate the requirement that the auditor add an uncertainties explanatory paragraph to the auditor's report, if certain criteria are met.

The proposed amendment would also expand the guidance in paragraph 37 of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards,* vol. 1, AU sec. 508), to indicate that "unusually important risks or uncertainties associated with contingencies, significant estimates, or concentrations" are matters that auditors may wish to emphasize in their reports. The proposed amendment retains the option allowing auditors to disclaim an opinion on financial statements due to uncertainties.

The proposal does not affect the provisions of SAS No. 59, which requires that the auditor add an explanatory paragraph to the auditor's report when there is substantial doubt about the entity's ability to continue as a going concern. The ASB hopes to finalize this SAS in late 1995 and to issue an SAS that would be effective for reports issued on or after June 30, 1996.

Comments on the proposed SAS were due October 20, 1995.

Accounting Developments

Mortgage Servicing Rights

FASB Statement No. 122 amends FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* (FASB, *Current Text*, vol. 2, sec. Mo4), to require that a mortgage banking enterprise recognize as separate assets rights to service mortgage loans for others, however those servicing rights are acquired. A mortgage banking enterprise that acquires mortgage servicing rights through either the purchase or origination of mortgage loans and sells or securitizes those loans with servicing rights retained is required by the Statement to allocate the total cost of the mortgage loans to the mortgage servicing rights and the loans (without the mortgage servicing rights) based on their relative fair values if it is practicable to estimate those fair values. If it is not practicable to estimate the fair values of the mortgage servicing rights and the mortgage loans (without the mortgage servicing rights), the Statement requires that the entire cost of purchasing or originating the loans should be allocated to the mortgage loans (without the mortgage servicing rights) and no cost should be allocated to the mortgage servicing rights.

FASB Statement No. 122 requires that a mortgage banking enterprise assess its capitalized mortgage servicing rights for impairment based on the fair value of those rights. The Statement requires that a mortgage banking enterprise should stratify its mortgage servicing rights that are capitalized after the adoption of the Statement based on one or more of the predominant risk characteristics of the underlying loans. The Statement requires that impairment should be recognized through a valuation allowance for each impaired stratum.

FASB Statement No. 122 applies prospectively in fiscal years beginning after December 15, 1995, to transactions in which a mortgage banking enterprise sells or securitizes mortgage loans with servicing rights retained and to impairment evaluations of all amounts capitalized as mortgage servicing rights, including those purchased before adoption, with earlier application encouraged. The Statement prohibits retroactive capitalization of mortgage servicing rights retained in transactions in which a mortgage banking enterprise originates mortgage loans and sells or securitizes those loans before the adoption.

In July 1995, the FASB staff announced that the Board agreed to clarify the transition provisions of FASB Statement No. 122, noting in FASB's Action Alert No. 95-21 that:

> ...earlier application is encouraged as of the beginning of a fiscal year for which annual financial statements or annual financial information has not been issued or as of the beginning of an interim period within that fiscal year for which interim financial statements or interim financial information has not been issued. For example, Public Company X issued financial information for the first quarter. In the second quarter, management of Public Company X has two choices for early adoption: (1) adopt as of the beginning of the fiscal year because annual financial statements or annual financial information has not been issued for that fiscal year or (2) adopt as of the beginning of the second quarter because interim financial statements or interim financial information has not been issued for that quarter.

Impairment of Long-Lived Assets

In March 1995, the FASB issued Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FASB, *Current Text*, vol. 1, sec. I08). FASB Statement No. 121 establishes accounting standards for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used, and for long-lived assets and certain identifiable intangibles to be disposed of. The Statement requires that long-lived assets and certain identifiable intangibles to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In performing the review for recoverability, the Statement requires that the institution estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset. (The fair value of an asset is the amount at which the asset could be bought or sold in a current transaction between willing parties.)

The Statement also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets covered by APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (FASB, *Current Text*, vol. 1, sec. I13). Assets covered by APB Opinion No. 30 will continue to be reported at the lower of the carrying amount or the net realizable value.

Paragraph 16 of FASB Statement No. 121 requires that assets to be disposed of that are within the scope of FASB Statement No. 121 should "not be depreciated (amortized) while they are held for disposal."

The Statement is effective for financial statements for fiscal years beginning after December 15, 1995, with earlier application encouraged. Restatement of previously issued financial statements is not permitted by the Statement. The Statement requires that impairment losses resulting from its application be reported in the period in which the recognition criteria are first applied and met. The Statement requires that initial application of its provisions to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle. (See "Foreclosed Assets" in the "Accounting Developments" section herein.)

Auditors of the financial statements of banks and savings institutions should consider management's policies and procedures for determining whether all impaired assets have been properly identified. Auditors should evaluate management's estimates of future cash flows from asset use and impairment losses following the guidance of SAS No. 57.

Disclosures About Derivatives

In October 1994, the FASB issued Statement No. 119, which requires disclosures about derivatives financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics. It also amends existing requirements of FASB Statements No. 105 and No. 107.

The Statement requires disclosures about amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. Paragraph 12 of FASB Statement No. 119 encourages, but does not require, entities to disclose quantitative information about risks associated with derivatives.

FASB Statement No. 119 was effective for financial statements issued for fiscal years ending after December 15, 1994, except for institutions with less than $150 million in total assets. For those institutions, the

Statement is effective for financial statements issued for fiscal years ending after December 15, 1995.

The FASB Special Report, *Illustrations of Financial Instrument Disclosures,* contains illustrations of the application of FASB Statements No. 105, No. 107, and No. 119, including specific illustrations of application by a domestic and an international financial institution.

Income Recognition on Impaired Loans

In October 1994, the FASB issued Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures* (FASB, *Current Text,* vol. 1, sec. I08), which amends FASB Statement No. 114 to allow creditors to use existing methods for recognizing interest income on impaired loans. To accomplish that, it eliminates the provisions in FASB Statement No. 114 that describe how creditors should report income on impaired loans.

FASB Statement No. 118 does not change the provisions in FASB Statement No. 114 that require creditors to measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the observable market price of the loan or the fair value of the collateral if the loan is collateral-dependent.

FASB Statement No. 118 also amends the disclosure requirements in FASB Statement No. 114 to require disclosure of information about the recorded investment in certain impaired loans and about how creditors recognize interest income related to those loans.

FASB Statement No. 118 is effective concurrent with the effective date of FASB Statement No. 114, that is, for financial statements for fiscal years beginning after December 15, 1994.

Impairment of a Loan

In May 1993, FASB Statement No. 114 was issued to address the accounting by creditors for impairment of certain loans. A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. The Statement is applicable to all creditors and to all loans, uncollateralized as well as collateralized, except large groups of smaller balance homogeneous loans that are collectively valued for impairment (for example, credit-card, residential mortgage, and consumer installment loans), loans that are measured at fair value or at the lower of cost or fair value, leases, and debt securities as defined in FASB Statement No. 115. It applies to all loans that are restructured in a troubled debt restructuring involving a modification of terms, including groups of smaller balance homogeneous loans that may otherwise have been excluded from the scope of the Statement.

FASB Statement No. 114 requires that impaired loans that are within its scope be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral-dependent. The impairment is recognized by creating or adjusting a valuation allowance for the impaired loan with a corresponding charge to bad debt expense.

The Statement amends FASB Statement No. 5, *Accounting for Contingencies* (FASB, *Current Text*, vol. 1, sec. C59), to clarify that a creditor should evaluate the collectibility of both the contractual interest and contractual principal of all receivables in assessing the need for a loss accrual. The Statement also amends FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (FASB, *Current Text*, vol. 1, sec. D22), to require a creditor to measure all loans that are restructured in a troubled debt restructuring involving a modification of terms in accordance with its provisions.

The Statement applies to financial statements for fiscal years beginning after December 15, 1994.

Offsetting

Accounting Principles Board (APB) Opinion No. 10, *Omnibus Opinion—1966* (FASB, *Current Text*, vol. 1, sec. B10), paragraph 7, says that "it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists." FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (FASB, *Current Text*, vol. 1, sec. B10), defines *right of setoff* and specifies what conditions must be met to permit offsetting. FASB Interpretation No. 41 modifies FASB Interpretation No. 39 to permit offsetting in the statement of financial position of payables and receivables that represent repurchase agreements and reverse repurchase agreements and that meet all of the conditions specified therein. FASB Interpretation No. 41 was effective for financial statements issued for periods ending after December 15, 1994.

Discussions of the FASB's EITF

The EITF frequently discusses accounting issues involving financial instruments, real estate, or transactions of similar importance to banks and savings institutions. A description of issues discussed during the year follows; readers should consult detailed minutes for additional information.

- EITF Issue No. 95-11, *Accounting for Derivative Instruments Containing Both a Written Option-Based Component and a Forward-Based Component,* addresses accounting for certain derivative instruments.
- EITF Issue No. 95-5, *Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights,* addresses certain issues related to sales of mortgage loan servicing rights.
- EITF Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination,* addresses what types of direct, integration, or exit costs to accrue as liabilities in a purchase business combination and when to recognize those costs.
- EITF Issue No. 95-2, *Determination of What Constitutes a Firm Commitment for Foreign Currency Transactions Not Involving a Third Party,* addresses what constitutes a significant economic penalty to a consolidated entity under EITF Issue No. 91-1, *Hedging Intercompany Foreign Currency Risks.*
- EITF Issue No. 94-9, *Determining a Normal Servicing Fee Rate for the Sale of an SBA Loan,* discusses how, when applying EITF Issue No. 88-11, *Allocation of Recorded Investment When a Loan or Part of a Loan is Sold,* an enterprise should determine a normal servicing fee rate for United States Small Business Administration (SBA) loans without a major secondary market maker. A secondary issue is how to account for a change in the normal servicing fee rate.
- EITF Issue No. 94-7, *Accounting for Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock,* addresses financial instruments that may be settled with a specified number of shares of an entity's stock or with a cash amount calculated on the basis of the value of a specified number of shares of an entity's stock. Issues include (1) whether the instrument should be classified as an asset or an equity instrument and (2) how gains and losses are reported.
- EITF Issue No. 94-5, *Determination of What Constitutes All Risks and Rewards and No Significant Unresolved Contingencies in a Sale of Mortgage Loan Servicing Rights under Issue No. 89-5,* involves accounting for transfers of mortgage-servicing rights.

Appendix D to the *EITF Abstracts* contains EITF discussions of technical matters that have long-term relevance and do not relate specifically to a numbered EITF Issue. Readers should be alert to the following topics of recent discussion:

- Appendix D-46, *Accounting for Limited Partnership Investments*, contains an announcement by the SEC staff concerning the application of the equity method to investments in limited partnerships.
- Appendix D-45 contains FASB staff views on *Implementation of FASB Statement No. 121 for Assets to Be Disposed Of.*
- Appendix D-44, *Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security Whose Cost Exceeds Fair Value,* contains a FASB staff announcement concerning implementation of FASB Statement No. 115.
- Appendix D-43 contains FASB staff views on *Assurance That a Right of Setoff Is Enforceable in a Bankruptcy under FASB Interpretation No. 39.*

Readers should consult the minutes for the following issues to understand the effect of issuance of FASB Statement No. 122 on related consensuses.

- EITF Issue No. 88-11, *Allocation of Recorded Investment When a Loan or Part of a Loan Is Sold*
- EITF Issue No. 86-39, *Gains from the Sale of Mortgage Loans with Servicing Rights Retained*
- EITF Issue No. 86-38, *Implications of Mortgage Prepayments on Amortization of Servicing Rights*

Readers should consult the minutes for the following issues to understand the effect of issuance of FASB Statement No. 121 on related consensuses.

- EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*
- EITF Issue No. 90-16, *Accounting for Discontinued Operations Subsequently Retained*
- EITF Issue No. 90-6, *Accounting for Certain Events Not Addressed in Issue No. 87-11 Relating to an Acquired Operating Unit to Be Sold*
- EITF Issue No. 87-11, *Allocation of Purchase Price to Assets to Be Sold*
- EITF Issue No. 84-28, *Impairment of Long-Lived Assets*

The issuance of FASB Statement No. 119 nullified the disclosure requirements in EITF Issue No. 91-4, *Hedging Foreign Currency Risks with Complex Options and Similar Transactions.*

Risks and Uncertainties

In December 1994, the AcSEC issued SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* SOP 94-6 requires institutions to include in their financial statements disclosures about (1) the nature of operations and (2) the use of estimates in the preparation of financial statements. In addition, if specified criteria are met, SOP 94-6 requires institutions to include in their financial statements disclosures about (1) certain significant estimates and (2) current vulnerability due to certain concentrations.

Paragraph 18 of SOP 94-6 gives examples of items that may be based on estimates that are particularly sensitive to change in the near term. Besides valuation allowances for commercial and real estate loans, examples of similar estimates often included in bank and savings institutions financial statements include:

- Impairment of long-lived assets, for example, assets related to marginal branches
- Estimates involving assumed prepayments, for example, discounts or premiums on financial assets (such as securities or loans), mortgage servicing rights and excess servicing receivables, and mortgage-related derivatives
- Lives of goodwill and identifiable intangible assets (for example, depositor or borrower relationships)

Examples of bank or savings institution concentrations that may be subject to disclosure if they meet the criteria of paragraph 21 of SOP 94-6 include:

- Sale of a substantial portion of or all receivables or loan products to a single customer
- Loss of approved status as a seller to or servicer for a third party
- Cancellation of a third-party guarantee program
- Concentration of revenue from mortgage banking activities

The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending subsequent to December 15, 1995, and for financial statements for interim periods in fiscal years after the year for which SOP 94-6 is first applied. Early application is encouraged but not required.

Auditors should be alert to the requirements of the new SOP and its impact on the financial statements they audit. Auditors should carefully consider whether all significant estimates and concentrations have been identified and considered for disclosure.

Foreclosed Assets

Certain provisions of SOP 92-3, *Accounting for Foreclosed Assets*, are inconsistent with provisions of FASB Statement No. 121. AcSEC is considering actions that it should take on SOP 92-3; however, FASB Statement No. 121 takes precedence for transactions within its scope.

SEC Staff Accounting Bulletin

SEC Staff Accounting Bulletin No. 94, *Recognition of a Gain or Loss on Early Extinguishment of Debt*, expresses SEC staff views about the period in which a gain or loss is recognized on the early extinguishment of debt.

Information Sources

Further information on matters addressed in this risk alert is available through various publications and services listed in the table at the end of this document. Many non-government and some government publications and services involve a charge or membership requirement.

Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow the user to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

All telephone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed for data lines.

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This Audit Risk Alert supersedes *Banks and Savings Institutions Industry Developments—1994.*

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Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1995/96* and *Compilation and Review Alert—1995/96,* which may be obtained by calling the AICPA Order Department at the number below and asking for product no. 022180 (audit) or 060669 (compilation and review).

Information Sources

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (800) TO-AICPA or (800) 862-4272 Information about AICPA continuing professional education programs is available through the AICPA CPE Division (ext. 3) and the AICPA Meetings and Travel Division: (201) 938-3232.	*24 Hour Fax Hotline* (201) 938-3787	*Accountants Forum* This information service is available on CompuServe. Some information is available only to AICPA members. To set up a CompuServe account call (800) 524-3388 and ask for the AICPA package or rep. 748.	
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10			*Action Alert Telephone Line* (203) 847-0700 (ext. 444)
Federal Home Loan Mortgage Corporation (Freddie Mac)	*Customer Service* 8200 Jones Branch Drive McLean, VA 22102-3107 (800) FREDDIE			
Federal Deposit Insurance Corporation	*Corporate Communications* 550 17th Street, NW Washington, DC 20429-0001 (202) 898-6996	*Facsimile Bulletin Board System* (804) 642-0003	*Electronic Bulletin Board System* Instructions are available through the FDIC's Facsimile Bulletin Board System. (804) 642-2737 (d)	*Action Update* (202) 898-7210
Federal Reserve System	*Publications Services* 20th and C Streets, NW Washington, DC 20551-0001 (202) 452-3245	*U.S. Department of Commerce STAT-USA/FAX* Some information is available to guest users. Other information requires a subscription fee. (202) 482-0005	*U.S. Department of Commerce's Economic Bulletin Board* Some information is available to guest users. Other information requires a subscription fee. HelpLine: (202) 482-1986 (202) 482-3870 (d-300/1200/2400 bps) (202) 482-2584 (d-9600 bps) (202) 482-2167 (d-14.4 kbps) Telnet access via Internet: ebb.stat-usa.gov	*Federal Reserve Board Highlights* (202) 452-3206 *Bank Holding Company Applications and Orders* (202) 452-3207

Mortgage Bankers Association of America	*Publications Department* 1125 15th Street, NW Washington, DC 20005-2766 (800) 793-MBAA, ext. 3	*MBA Fax on Demand* This service is available only to MBA members. For more information, call (800) 793-MBAA.		
U.S. Department of the Treasury— **Office of the Comptroller of the Currency**	*Publications Control* P.O. Box 70004 Chicago, IL 60673-0004 (202) 874-4884	*OCC Information Line* (202) 479-0141	*U.S. Treasury's Electronic Library (TEL)* (703) 321-3339 (d) Via internet: ftp.fedworld.gov (192.239.92.205) Telnet via Internet: fedworld.gov (192.239.93.3) FTP via Internet: ftp.fedworld.gov (192.239.92.205) World Wide Web home page: http://www.fedworld.gov	
U.S. Department of the Treasury— **Office of Thrift Supervision**	*OTS Dissemination Branch* 1700 G Street, NW Washington, DC 20552-0001 (202) 906-6427	The OTS is developing a fax service that they may launch in late 1995.		
U.S. Department of Education	*Federal Student Aid Information Center* (800) 433-3243			
U.S. General Accounting Office	*Superintendent of Documents* U.S. Government Printing Office Washington, DC 20401-0001 (202) 512-1800 (202) 512-2250 (f)		*U.S. Government Printing Office's The Federal Bulletin Board* Includes *Federal Register* notices and the Code of Federal Regulations. Users are usually expected to open a deposit account. User assistance line: (202) 512-1530 (202) 512-1387 (d) Telnet via internet: federal.bbs.gpo.gov 3001	
U.S. Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8079	*Information Line* (202) 942-8088, ext. 3 (202) 942-7114 (tty)	World Wide Web home page: http://=www.sec.gov	*Information Line* (202) 942-8088 (202) 942-7114 (tty)

Examiner-Auditor Relationship

The following excerpt from the proposed AICPA Audit and Accounting Guide *Banks and Savings Institutions* provides guidance on coordination between examiners and auditors. The Guide incorporates and supersedes AICPA Statement of Position (SOP) 90-5, *Inquiries of Representatives of Financial Institution Regulatory Agencies,* and related sections of the AICPA Audit and Accounting Guide *Audits of Savings Institutions.*

> Independent accountants may be engaged to attest to the fairness of presentation of the institution's financial statements and to management's assertions about the institution's financial reporting controls and compliance with laws and regulations. Banking regulators conduct periodic on-site examinations to address broader regulatory and supervisory issues. There are some objectives shared by examiners and independent accountants, and coordination in consultation with the institution may be beneficial.
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> The primary objective of communicating with examiners is to ensure that independent accountants consider competent evidential matter produced by examiners before expressing an opinion on audited financial statements. In areas such as the adequacy of credit loss allowances and violations of laws or regulations, for example, information known to or judgments made by examiners should be made known to management and the independent accountant before financial statements are issued or an audit opinion is rendered. Such communication will minimize the possibility that a regulatory agency will subsequently require restatement—based on the examiner's additional knowledge or different judgment—of call reports and affect the general purpose financial statements, on which the independent accountant has already expressed an opinion, dated during or subsequent to the period in which a regulatory examination was being conducted.
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> [Federal Deposit Insurance Act] Section 36(h) requires that each institution provide its independent accountant with copies of the institution's most recent call report and examination report (see [Title 12 of the Code of Federal Regulations] Subpart 363.403). The institution must also provide the independent accountant with any of the following documents related to the period covered by the engagement:
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> *a.* Any memorandum of understanding (MOU) or other written agreement between the institution and any federal or state banking agency

b. The report of any action initiated or taken by any federal or state banking agency, including any assessment of civil money penalties

The independent accountant should review communications from examiners and, when appropriate, make inquiries of examiners. Specifically, the independent accountant should—

a. Request that management provide access to all reports of examination and related correspondence.

b. Review the reports of examination and related correspondence between examiners and the institution during the period under audit and through the date of the independent accountant's opinion.

c. With prior approval of the institution, communicate with the examiners if their examination is still in process, the institution's appeal of an examination finding is outstanding, or their examination report is still pending.

d. With prior approval of the institution, consider attending, as an observer, the exit conference between the examiner and the institution's board of directors, its executive officers, or both.

The independent accountant's attendance at other meetings between examiners and representatives of the institution requires prior approval by the regulatory agency.

Independent accountants may request a meeting with the appropriate regulatory representatives to inquire about supervisory matters relevant to the client institution. Management of the institution would generally be present at such a meeting, and matters discussed would generally be limited to findings already presented to management. Federal regulatory policy also permits meetings between examiners and independent accountants in the absence of the institution's management.[1] In addition, the [Office of Thrift Supervision (OTS)] has established a policy that generally makes OTS examination working papers available for review.[2]

Management refusal to furnish access to reports or correspondence, or to permit the independent accountant to communicate with the examiner, would ordinarily be a limitation on the scope

[1] Related instructions to examiners were published in a July 23, 1992, *Interagency Policy Statement on Coordination and Communication Between External Auditors and Examiners.*

[2] See OTS letter to chief executive officers dated September 11, 1992.

of a financial statement audit sufficient to preclude an opinion. Refusal by an examiner to communicate with the independent accountant may create the same scope limitation, depending on the independent accountant's assessment of the circumstances (see paragraphs 40-44 of [Statement on Auditing Standards (SAS)] No. 58, *Reports on Audited Financial Statements* [AICPA, *Professional Standards*, vol. 1, AU sec. 508], for additional guidance).

Examiners might request permission to attend the meeting between the independent accountant and representatives of the institution (for example, the audit committee of the board of directors) to review the independent accountant's report on the institution's financial statements. If such a request is made and management concurs, the independent accountant should be responsive to the request.

Examiners and others may, from time to time, request auditors of financial statements of banks and savings institutions to provide access to working papers. Auditors who have been requested to provide such access should refer to [Interpretation No. 1 of SAS No. 41, *Working Papers*, titled "Providing Access to or Photocopies of Working Papers to a Regulator" (AICPA, *Professional Standards*, vol. 1, AU sec. 9339)]. The Interpretation provides auditors with guidance on—

- Advising management that the regulator has requested access to (and possibly photocopies of) the working papers and that the auditor intends to comply with the request.
- Making appropriate arrangements with the regulator for the review.
- Maintaining control over the original working papers.
- Considering submitting to the regulator a letter clarifying that an audit in accordance with GAAS is not intended to, and does not, satisfy a regulator's oversight responsibilities. An example of such a letter is illustrated in paragraph 6 of the Interpretation.

In addition, the Interpretation addresses situations in which an auditor has been requested by a regulator to provide access to the working papers before the audit has been completed and the report released. Also, the Interpretation notes that when a regulator engages an independent party, such as another independent public accountant, to perform the working paper review on behalf of the regulatory agency, there are some precautions auditors should observe.

Information in examination reports, inspection reports, supervisory discussions—including summaries or quotations—is considered confidential. Such information may not be disclosed to any party without the written permission of the appropriate agency, and unauthorized disclosure of such information could subject the independent accountant to civil and criminal enforcement actions.